Measuring The Reaction of Monetary Policy to the Stock Market Get access >

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Abstract

Movements in the stock market can have a significant impact on the macroeconomy and are therefore likely to be an important factor in the determination of monetary policy. However, little is known about the magnitude of the Federal Reserve's reaction to the stock market, in part because the simultaneous response of equity prices to interest rates makes it difficult to estimate. This paper uses an identification technique based on the heteroskedasticity of stock market returns to measure the reaction of monetary policy to the stock market. We find a significant policy response, with a 5 percent rise (fall) in the S&P 500 index increasing the likelihood of a 25 basis point tightening (easing) by about a half.

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